

REPORT OF EXAMINATION  
OF THE  
MEDICAL INSURANCE EXCHANGE  
OF CALIFORNIA

AS OF  
DECEMBER 31, 2005

Participating State  
and Zone:

California

Filed May 18, 2007

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San Francisco, California  
April 5, 2007

Honorable Alfred W. Gross  
Chairman of the NAIC Financial  
Condition (EX4) Subcommittee  
Commissioner of Insurance  
Virginia Bureau of Insurance  
Richmond, Virginia

Honorable Kent Michie  
Secretary, Zone IV-Western  
Commissioner of Insurance  
Department of Insurance, State of Utah  
Salt Lake City, Utah

Honorable Steve Poizner  
Insurance Commissioner  
California Department of Insurance  
Sacramento, California

Dear Chairman and Commissioners:

Pursuant to your instructions, an examination was made of the

#### MEDICAL INSURANCE EXCHANGE OF CALIFORNIA

(hereinafter also referred to as the Exchange) at its home office located at 6250 Claremont Avenue, Oakland, California 94618.

#### SCOPE OF EXAMINATION

The previous examination of the Exchange was made as of December 31, 2002. This examination covers the period from January 1, 2003 through December 31, 2005. The examination was conducted pursuant to the National Association of Insurance Commissioners' plan of examination. The examination included a review of the Exchange's practices and procedures, an examination of management records, tests and analyses of detailed transactions, and an evaluation of assets and a determination of liabilities as of December 31, 2005, as deemed necessary under the circumstances. The examination was conducted concurrently with that of the Exchange's subsidiary, Claremont Liability Insurance Company.

In addition to those items specifically commented upon in this report, other phases of the Exchange's operations were reviewed including the following areas that require no further comment: Exchange history; corporate records; fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; growth of Exchange; business in force by states; loss experience; and sales and advertising.

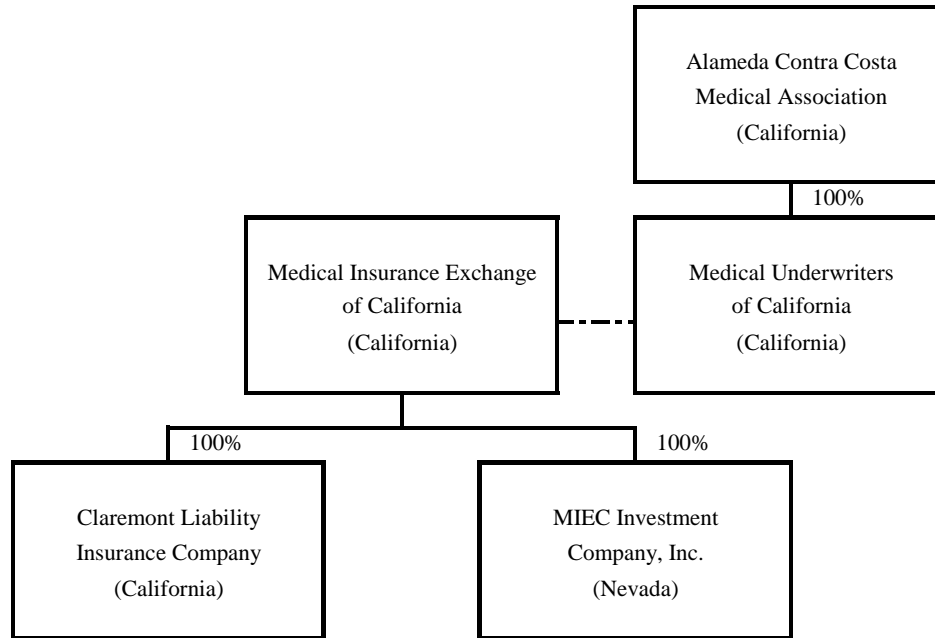
### SUBSEQUENT EVENTS

The Exchange's subsidiary, Claremont Liability Insurance Company (CLIC), is in the process of re-filing Schedule "F", Part 6 and 7 of its 2006 Annual Statement. The re-filing is for the purposes of correcting errors that were noted and reclassifying certain overdue reinsurance recoverables totaling \$697,000 as "in dispute." The reclassification of the overdue recoverables as "in dispute" is based on the CLIC and the Exchange's (Companies) position that the dispute with respect to reinsurance recoverables from another claim (Redding) within the same reinsurance program can be ascribed to the recoverables in question. The Companies plan to work with the California Department of Insurance with respect to whether the Companies' position that the overdue recoverables are "in dispute" adheres to statutory accounting principles. Not reclassifying the recoverables as "in dispute," would necessitate CLIC to increase its provision for reinsurance by \$1.977 million, thereby reducing its surplus by the same amount. The Exchange's surplus would also be reduced by \$1.977 million through its ownership of CLIC less a reduction of \$474,915 in Schedule "F" penalties arising from its own related overdue recoverables. If booked, the amounts would not have a material impact on the Companies.

### MANAGEMENT AND CONTROL

The Exchange is a reciprocal and is therefore owned by its policyholders. All officers and members of the board of governors are physicians. Except for its officers, the Exchange has no employees. The Exchange is managed by its attorney-in-fact, Medical Underwriters of California (MUC), pursuant to an administrative services agreement. MUC is 100% owned by the Alameda Contra-Costa Medical Association. The Exchange is part of a holding company

system, which includes two wholly-owned subsidiaries. The following chart depicts the companies within the holding company system:



----- Attorney-in-Fact for Medical Insurance Exchange of California

Management of the Exchange is vested in a fifteen-member board of governors. A listing of the board members and principal officers serving on December 31, 2005 follows:

### Governors

| <u>Name and Residence</u>  | <u>Principal Business Affiliation</u> |
|--|---------------------------------------|
| Bradford P. Cohn, M.D., Chairman<br>Napa, California                             | Physician                             |
| William G. Donald, Jr., M.D., Vice Chairman <sup>1</sup><br>Berkeley, California | Physician                             |
| Conrad E. Anderson, M.D., Secretary <sup>2</sup><br>Fremont, California          | Physician                             |

<sup>1</sup> Retired December 31, 2005. Replaced by Ann Louise Vercoutere, M.D.

<sup>2</sup> Retired December 31, 2005. Replaced by Scott Andrew Hoffinger, M.D.

| <u>Name and Residence</u>                                       | <u>Principal Business Affiliation</u> |
|---|---------------------------------------|
| Clarence S. Avery, M.D. <sup>3</sup><br>Oakland, California     | Physician                             |
| James G. Campbell, M.D. <sup>4</sup><br>Redding, California     | Physician                             |
| Thayer E. Cleaver, M.D.<br>Mt. Shasta, California               | Physician                             |
| Ronald V. Dorn III, M.D.<br>Boise, Idaho                        | Physician                             |
| Fernando V. Dulay, M.D.<br>Daly City, California                | Physician                             |
| James O. Gemmer, M.D.<br>Suisun, California                     | Physician                             |
| Charles L. Hoffman, M.D. <sup>5</sup><br>San Rafael, California | Physician                             |
| Harry Lee Jr., M.D. <sup>6</sup><br>San Francisco, California   | Physician                             |
| Mark Oscherwitz, M.D.<br>San Francisco, California              | Physician                             |
| Lamont D. Paxton, M.D.<br>San Leandro, California               | Physician                             |
| Douglas G. Smith, M.D.<br>Anchorage, Alaska                     | Physician                             |
| Russell T. Stodd, M.D.<br>Kahului, Hawaii                       | Physician                             |

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<sup>3</sup> Term expired December 31, 2006. Replaced by Toni Brayer, M.D.

<sup>4</sup> Deceased May 2006. Not yet replaced.

<sup>5</sup> Term expired December 31, 2006. Replaced by Robert Margolin, M.D.

<sup>6</sup> Term expired December 31, 2006. Replaced by Cheryl Tanasovich, M.D.

## Principal Officers

| <u>Name</u>                    | <u>Title</u>  |
|--------------------------------|---------------|
| Bradford P. Cohn, M.D.         | Chairman      |
| William G. Donald, Jr., M.D. * | Vice Chairman |
| Conrad E. Anderson, M.D. **    | Secretary     |

\* Replaced by James Owen Gemmer, M.D. in 2006.

\*\* Replaced by Mark Oscherwitz, M.D. in 2006.

## Inter-Company Agreements

*Administrative Services Agreement:* Pursuant to the agreement, the Exchange's attorney-in-fact, Medical Underwriters of California (MUC), manages the daily operations of the Exchange and its subsidiaries on a cost-reimbursement basis. Services provided under the agreement include: solicitation of business, underwriting and policy issuance, premium collection, accounting, and claim adjustment services. The agreement was approved by the California Department of Insurance on August 11, 2004.

*Tax Allocation Agreement:* The Exchange is party to a tax allocation agreement with its subsidiaries Claremont Liability Insurance Company and MIEC Investment Company, Inc. The agreement which became effective May 26, 1996 provides for the federal tax returns of the parties to be filed on a consolidated basis. Allocation is based on separate company return calculations with current credit given to a company for net losses or tax credits to the extent losses and/or credits result in an actual reduction to the consolidated group's tax liability.

## TERRITORY AND PLAN OF OPERATION

The Exchange writes medical professional liability and legal defense insurance coverage on a claims-made basis for physicians, group practices, blood banks, and clinics. Prior acts "nose" coverage is available for claims arising from occurrences prior to the effective date of the policy and "tail" coverage for claims arising from occurrences before termination but reported

after the termination of the policy. “Tail” coverage is provided at no additional charge to certain deceased, disabled and retired physicians who meet predetermined requirements. Other coverages provided include: incidental office premises liability, fire, legal defense liability and employer’s non-owned private passenger automobile insurance. All policies are written with a February 1st effective date.

The Company is licensed to write in the states of Alaska, Arizona, California, Hawaii, Idaho, Montana, Nevada, Oregon and Washington. In 2005, direct premiums written were: \$10 million (14%) in Alaska, \$37 million (52%) in California, \$15 million (21%) in Hawaii, \$9 million (13%) in Idaho, and \$94,000 (less than 1%) in the states of Nevada and Washington.

## REINSURANCE

### Assumed

The Exchange participated with other reinsurers on a number of assumed contracts written on an excess basis. These contracts covered medical professional liability policies written on medical providers, hospitals, blood banks, and health care organizations. Three of the four contracts in which the Exchange participated were formally assumed by Claremont Liability Insurance Company (CLIC) until 2002, at which time CLIC discontinued all assumed reinsurance.

### Ceded

The Exchange had the following ceded reinsurance contracts with either authorized insurers or Lloyd’s syndicates in force at December 31, 2005:



| <u>Type of Contract</u>    | <u>Reinsurers</u>  | <u>Exchange Retention</u>   | <u>Reinsurer's Maximum Limits</u>  |
|----------------------------|--|---|--|
| Excess Cession             | Lloyd's Underwriters (30.0%)<br>Hannover Ruckversicherungs – AG (25.0%)<br>Transatlantic Reinsurance Company (20.0%)<br>Platinum Underwriters Reinsurance, Inc. (15.0%)<br>Berkley Insurance Company (10.0%) | \$2 million each loss per policy/<br>\$4 million in the aggregate per policy                                  | \$3 million excess of \$2 million each loss per policy/<br>\$3 million excess of \$4 million in the aggregate per policy                                   |
| "Clash" Excess of Loss     | Lloyd's Underwriters (60.0%)<br>Transatlantic Reinsurance Company (15.0%)<br>Platinum Underwriters Reinsurance, Inc. (15.0%)<br>Berkley Insurance Company (10.0%)  | \$4 million each loss occurrence where two or more insureds are involved in the same loss occurrence          | \$4 million excess of \$4 million each loss occurrence where two or more insureds are involved in the same loss occurrence                                 |
| Catastrophe Excess of Loss | Lloyd's Underwriters (92.86%)<br>Aspen Insurance UK Limited (7.14%)  | Section (A): either \$2 million or \$4 million depending on inuring reinsurance<br><br>Section (B): \$250,000 | Section (A): \$10 million excess of either \$2 million or \$4 million depending on inuring reinsurance<br><br>Section (B): \$5 million excess of \$250,000 |

## ACCOUNTS AND RECORDS

### Information Systems Controls

During the course of the examination, a review was made of the Exchange's general controls over its information systems. As a result of the review, recommendations were made to strengthen controls in the following areas: disaster recovery/business continuity planning, application development and program change controls, privacy and confidentiality of private and financial information, system development life cycles standards, and documentation standards. The examination findings were presented to the Exchange along with

recommendations to strengthen its controls. The Exchange should evaluate the recommendations and make appropriate changes to strengthen its information system controls.

### FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2005

Underwriting and Investment Exhibit for the Year Ended December 31, 2005

Reconciliation of Surplus as Regards Policyholders from December 31, 2002  
through December 31, 2005

Statement of Financial Condition  
as of December 31, 2005

| <u>Assets</u>   | <u>Ledger and<br/>Nonledger<br/>Assets</u> | <u>Nonadmitted<br/>Assets</u> | <u>Net Admitted<br/>Assets</u> | <u>Notes</u> |
|---|--|-------------------------------|--------------------------------|--------------|
| Bonds   | \$246,504,214                              | \$                            | \$246,504,214                  | (1)          |
| Preferred stocks  | 2,398,000                                  |                               | 2,398,000                      | (1)          |
| Common stocks   | 40,526,623                                 |                               | 40,526,623                     | (1)          |
| Properties occupied by the company  | 1,404,567                                  |                               | 1,404,567                      |              |
| Cash, cash equivalents and short-term investments   | 6,281,208                                  |                               | 6,281,208                      |              |
| Receivable for securities   | 500,000                                    |                               | 500,000                        |              |
| Investment income due and accrued   | 2,573,069                                  |                               | 2,573,069                      |              |
| Uncollected premiums and agents' balances<br>in the course of collection                    | 154,503                                    | 4,658                         | 149,845                        |              |
| Deferred premiums, agents' balances and installments<br>booked but deferred and not yet due | 3,760,853                                  |                               | 3,760,853                      |              |
| Amounts recoverable from reinsurers   | 7,498,406                                  |                               | 7,498,406                      |              |
| Funds held by or deposited with reinsured companies   | 149,721                                    |                               | 149,721                        |              |
| Net deferred tax asset  | 11,114,583                                 | 6,177,191                     | 4,937,392                      |              |
| Guaranty funds receivable or on deposit   | 12,638                                     |                               | 12,638                         |              |
| Receivables from parent, subsidiaries and affiliates  | 1,319,053                                  |                               | 1,319,053                      |              |
| Aggregate write-ins for other than invested assets  | <u>32,948</u>                              | <u>32,948</u>                 |                                |              |
| Total assets  | <u>\$324,230,386</u>                       | <u>\$ 6,214,797</u>           | <u>\$318,015,589</u>           |              |
| <u>Liabilities, Surplus and Other Funds</u>   |  |                               |                                |              |
| Losses  |  |                               | \$ 98,525,866                  | (2)          |
| Loss adjustment expenses  |  |                               | 50,538,744                     | (2)          |
| Other expenses (excluding taxes, licenses and fees)   |  |                               | 126,774                        |              |
| Taxes, licenses and fees (excluding federal and foreign income taxes)                       |  |                               | 199,361                        |              |
| Current federal and foreign income taxes  |  |                               | 119,504                        |              |
| Unearned premiums   |  |                               | 32,211,398                     |              |
| Advance premiums  |  |                               | 6,250,436                      |              |
| Dividends declared and unpaid: policyholders  |  |                               | 4,957,868                      |              |
| Ceded reinsurance premiums payable  |  |                               | 8,537,102                      |              |
| Amounts withheld or retained by company for account of others                               |  |                               | 4,259,072                      |              |
| Provision for reinsurance   |  |                               | 2,359,232                      |              |
| Payable to parent, subsidiaries and affiliates  |  |                               | 1,085,365                      |              |
| Aggregate write-ins for liabilities   |  |                               | <u>490,000</u>                 |              |
| Total liabilities   |  |                               | 209,660,722                    |              |
| Unassigned funds (surplus)  |  | <u>\$108,354,867</u>          |                                |              |
| Surplus as regards policyholders  |  |                               | <u>108,354,867</u>             |              |
| Total liabilities, surplus and other funds  |  |                               | <u>\$318,015,589</u>           |              |

Underwriting and Investment Exhibit  
for the Year Ended December 31, 2005

Statement of Income

Underwriting Income

|                                      |                  |                   |
|--------------------------------------|------------------|-------------------|
| Premiums earned                      |                  | \$71,488,478      |
| Deductions:                          |                  |                   |
| Losses incurred                      | \$30,481,302     |                   |
| Loss expenses incurred               | 27,101,633       |                   |
| Other underwriting expenses incurred | <u>9,143,084</u> |                   |
| Total underwriting deductions        |                  | <u>66,726,019</u> |
| Net underwriting gain                |                  | 4,762,459         |

Investment Income

|                              |                |            |
|------------------------------|----------------|------------|
| Net investment income earned | \$12,295,656   |            |
| Net realized capital gain    | <u>180,613</u> |            |
| Net investment gain          |                | 13,476,269 |

Other Income

|   |            |                      |
|---|------------|----------------------|
| Net loss from agents' balances charged off                                      | \$ (2,237) |                      |
| Total other income  |            | <u>(2,237)</u>       |
| Net income before dividends to policyholders<br>and before federal income taxes |            | 18,236,491           |
| Dividends to policyholders  |            | 5,000,000            |
| Federal income taxes incurred   |            | <u>281,378</u>       |
| Net income  |            | <u>\$ 12,955,113</u> |

Capital and Surplus Account

|   |                 |                      |
|---|-----------------|----------------------|
| Surplus as regards policyholders, December 31, 2004     |                 | \$ 99,743,199        |
| Net income  | \$12,955,113    |                      |
| Change in net unrealized capital loss                   | (518,675)       |                      |
| Change in net deferred income tax                       | (5,186,192)     |                      |
| Change in nonadmitted assets                            | 3,733,654       |                      |
| Change in provision for reinsurance                     | (2,359,232)     |                      |
| Aggregate write-ins for losses in surplus               | <u>(13,000)</u> |                      |
| Change in surplus as regards policyholders for the year |                 | <u>8,611,668</u>     |
| Surplus as regards policyholders, December 31, 2005     |                 | <u>\$108,354,867</u> |

Reconciliation of Surplus as Regards Policyholders  
from December 31, 2002 through December 31, 2005

|   |                             |                            |                      |
|---|-----------------------------|----------------------------|----------------------|
| Surplus as regards policyholders,<br>December 31, 2002, per Examination |                             |                            | \$ 81,795,737        |
|   | <u>Gain in<br/>Surplus</u>  | <u>Loss in<br/>Surplus</u> |                      |
| Net income  | \$22,039,054                | \$                         |                      |
| Change in net unrealized capital gains                                  | 3,974,582                   |                            |                      |
| Change in net deferred income tax                                       | 509,208                     |                            |                      |
| Change in nonadmitted assets  | 2,755,517                   |                            |                      |
| Change in provision for reinsurance                                     |                             | 2,346,232                  |                      |
| Aggregate write-ins for gains in surplus                                | <u>                    </u> | <u>372,999</u>             |                      |
| Total gains and losses  | <u>\$29,278,361</u>         | <u>\$ 2,719,231</u>        |                      |
| Net increase in surplus as regards policyholders                        |                             |                            | <u>26,559,130</u>    |
| Surplus as regards policyholders,<br>December 31, 2005, per Examination |                             |                            | <u>\$108,354,867</u> |

## COMMENTS ON FINANCIAL STATEMENT ITEMS

### (1) Bonds and Stocks

Because Wells Fargo Bank, N.A., the Exchange's custodian, moved its headquarters from California to South Dakota, it is no longer considered a "qualified custodian" as defined by California Insurance Code (CIC) Section 1104.9. It is recommended the Exchange deposit its securities with a qualified custodian, subcustodian, or depository located in California per CIC Section 1104.9 and enter into an approved custodial agreement.

### (2) Losses and Loss Adjustment Expenses

The Exchange's reserves for losses and loss adjustment expenses were reviewed by a California Department of Insurance Casualty Actuary and were determined to be reasonable.

## SUMMARY OF COMMENTS AND RECOMMENDATIONS

### Current Report of Examination

Accounts and Records - Information Systems Controls (Page 7): It is recommended that the Exchange review the recommendations made regarding its information systems and make appropriate changes to strengthen internal controls.

Bonds and Stocks (Page 12): It is recommended the Exchange deposit its securities with a qualified custodian, subcustodian, or depository located in California per California Insurance Code Section 1104.9 and enter into an approved custodial agreement.

### Previous Report of Examination

Reinsurance – Ceded (Page 8): It was recommended that the Exchange amend the insolvency provisions of its reinsurance agreements to conform to CIC requirements. All reinsurance agreements now have acceptable insolvency clauses.

Accounts and Records (Page 10): It was recommended that the Exchange report inter-company receivables and payables separately in its Annual Statement. The Exchange has complied.

Accounts and Records (Page 10): It was recommended that the Exchange properly record ceded reinsurance balances in its Schedule “P”. The Exchange has complied.

Accounts and Records (Page 10): It was recommended that the Exchange review its control procedures over claims transactions to determine whether strengthening of the controls is needed to ensure that the number of clerical errors within its database is kept to a minimum. The Exchange has implemented workflow procedures to address this issue.

Accounts and Records (Page 10): It was recommended that the Exchange review its loss reserving procedures to determine whether it needs to be modified to ensure that claims are opened and reserve changes made on a timelier basis. The Exchange has implemented controls to address this issue.

Accounts and Records (Page 10): It was recommended that the Exchange make changes to its claims system and procedures to ensure that claims data is accurate. The Exchange has made changes which have corrected the earlier problems.

Accounts and Records (Page 10): It was recommended the Exchange properly disclose related party transactions with Medical Underwriters of California in its Annual Statement. Proper disclosure is now being made.

Accounts and Records – Information Systems Controls (Page 12): It was recommended that the Exchange evaluate the recommendations from the information system control review and make appropriate changes to strengthen its information system controls. Review of those controls for this examination indicated the Exchange had made appropriate changes, with the exception of application development/program change controls and privacy policy and procedures.

Comments on Financial Statement Items - Common Stocks (Page 17): It was recommended the Exchange report holding company activities in accordance with CIC Section 1215.4. Holding company activities are now being properly reported.

Comments on Financial Statement Items - Receivable from Parent, Subsidiaries and Affiliates (Page 18): It was recommended the Exchange report transactions with its subsidiaries in accordance with CIC Section 1215.4. No exceptions were noted regarding CIC Section 1215.4 compliance for this examination period.

Comments on Financial Statement Items - Losses and Loss Adjustment Expenses (Page 18): It was recommended that the Exchange develop a more comprehensive Claim Procedures Manual. A new Claims Procedures Manual has been adopted.

Comments on Financial Statement Items - Losses and Loss Adjustment Expenses (Page 19): It was recommended that the Exchange establish an individual claim for each claimant that has filed a lawsuit or has attorney representation in its claims system. The Exchange has complied with the recommendation.

Comments on Financial Statement Items - Unearned Premiums (Page 19): It was recommended that the Exchange revise its methodology for calculating its DD&R reserve. The Exchange revised its methodology in 2004 as recommended.



## ACKNOWLEDGEMENT

Acknowledgement is made of the courtesy and cooperation extended by the Exchange's officers and the employees of Medical Underwriters of California during the course of this examination.

Respectfully submitted,

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Isabel Spiker, CFE  
Examiner-In-Charge  
Senior Insurance Examiner  
Department of Insurance  
State of California